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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION ONE

**FILED**

MAR 30 2006

Court of Appeal - First App. Dist.  
DIANA HERBERT

By \_\_\_\_\_ DEPUTY

THE MCGRAW-HILL COMPANIES,  
INC.,

Plaintiff and Appellant,

v.

FRANCHISE TAX BOARD,

Defendant and Respondent.

A109907

(San Francisco County  
Super. Ct. No. CGC-03-424737)

Plaintiff, the McGraw-Hill Companies, Inc. (McGraw-Hill) sought to file amended state tax returns for tax years 1993 and 1994. In doing so it changed its accounting method to implement the "mark-to-market" method for customer paper it held at the end of those tax years. Respondent, the Franchise Tax Board (FTB) disallowed the claims for refund that accompanied the amended returns, and the State Board of Equalization (SBE) affirmed that decision. After McGraw-Hill filed a complaint in the superior court to obtain judicial review, the FTB obtained summary judgment in its favor. McGraw-Hill claims the court erred in granting FTB's motion for summary judgment. We affirm because McGraw-Hill failed to bring itself within the controlling FTB Legal Ruling to utilize mark-to-market accounting.

## Background

In 1993, Congress enacted former section 475 of the Internal Revenue Code (former IRC section 475). Former IRC section 475<sup>1</sup> applied to taxable years ending on or after December 31, 1993. (Pub.L. No. 103-66, § 13223(a), (c) (Aug. 10, 1993) 107 Stat. 312, 481-485; see now 26 U.S.C. § 475.) It required a “dealer in securities” to treat securities that it held at the close of a tax year as if it had sold them on the last business day of that year at their current fair market value, and to declare the gain or loss resulting from the hypothetical sale in its federal tax return for that year. (See Rev. Rul. 93-76, 1993-2 C.B. 235 (Rev. Rul. 93-76); Pub.L. No. 103-66, § 13223(a) (Aug. 10, 1993) 107 Stat. 312, 481; 26 U.S.C. § 475(a).) In effect, the section required dealers in securities to use the mark-to-market method of accounting<sup>2</sup> to measure their federal income tax liability with respect to the securities they held at the close of a tax year. (See Rev. Rul.

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<sup>1</sup> IRC section 475 has been amended several times since 1993, but the provisions relevant to this appeal are those of the former section as originally enacted.

<sup>2</sup> “Mark-to-market” is the act of assigning a value to an individual’s or entity’s interest in a tradable financial instrument that is based on the current market price for that instrument. The practice began in the 19th century among commodities dealers employing a “margin system” under which dealers would mark their transactions to market value at the end of each trading day. A dealer who ended the day with gains would receive from the exchange the amount exceeding the dealer’s margin account—the deposit made to the exchange as collateral to ensure the dealer would be able to perform under a futures contract. A dealer who ended the day with losses might face a “margin call” to make an additional deposit. Such dealers used the “mark-to-market” method for financial accounting to “mark” both inventory and futures contracts to market value at the end of each reporting period in order to measure unrealized losses and gains occurring since the last reporting period. (See Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor* (2004) 24 Va. Tax Rev. 301, 323, fn. 52, 325-326, fn. 57.) The requirement of using the mark-to-market method for tax accounting purposes, set out in former section 475, was designed to enable federal taxation of securities dealers’ unrealized gain as income, just as such dealers had previously been able to recognize unrealized loss for federal tax purposes. (See Halperin, *A Capital Gains Preference is Not Even a Second-Best Solution* (1993) 48 Tax L.Rev. 381, 384-385; see also Brown, “Complete” Accrual Taxation (1996) 33 San Diego L.Rev. 1559, 1566.)

93-76; Howell, Important Developments During the Year—Financial Transactions (1994) 44 Tax Law. 1197.)

In 1995, the FTB concluded that “[a]lthough California ha[d] not [yet] conformed to [former IRC section] 475,”<sup>3</sup> it was “permissible” under state law for dealers in securities to use the mark-to-market method of accounting. (Cal. Franchise Tax Bd., Legal Ruling No. 95-6 (Nov. 3, 1995) (Legal Ruling 95-6).) The FTB therefore concluded that it was permissible—but not required—for a taxpayer to make a change in its state tax returns in order to implement the mark-to-market accounting method for securities the taxpayer held at the close of a taxable year ending on or after December 31, 1993, when that taxpayer had been “required” to make such a change for federal tax purposes by former IRC section 475. (Legal Ruling 95-6.) Because most taxpayers had filed their state tax returns for tax years 1993 and 1994 by the time of the ruling, the ruling held also that it was permissible for such taxpayers to file amended returns for those years to make the change. But the FTB limited this permission, by requiring that any such amended returns be filed no later than March 31, 1996. The ruling stated that any taxpayer who failed to meet this deadline would be deemed to have made an election to maintain the accounting method it had used in its originally filed state tax returns. (Legal Ruling 95-6.)

For the tax years 1993 and 1994, McGraw-Hill did not initially file federal tax returns using the mark-to-market method required by former IRC section 475. Later, however, in October and December of 1997, McGraw-Hill filed amended federal tax returns for those years, that implemented the mark-to-market accounting method for “customer paper” that McGraw-Hill held at the close of those years. In December 1998, the Internal Revenue Service (IRS) allowed McGraw-Hill’s amended federal tax returns.

In March 1999, McGraw-Hill filed amended state tax returns for tax years 1993 and 1994, making the same changes it had made in its federal tax returns for those years.

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<sup>3</sup> Subsequently enacted state law now conforms to the provisions of IRC section 475. The conforming statutes apply to taxable years starting on or after January 1, 1997. (See Stats. 1996, ch. 954, §§ 22, 51, pp. 5554, 5603-5604; see now Rev. & Tax. Code, §§ 17570, 24710.)

In these amended state tax returns McGraw-Hill took the position that it was a “dealer in securities” required by former IRC section 475 to implement the mark-to-market accounting method, for federal tax purposes, with respect to customer paper it held at the close of those tax years. As such, McGraw-Hill reasoned it was entitled to amend its previously filed state tax returns for 1993 and 1994 to implement the same change, pursuant to Legal Ruling 95-6. McGraw-Hill calculated that as a result it was entitled to refunds in the amount of \$534,430 for 1993 and \$33,888 for 1994.

The FTB disallowed McGraw-Hill’s refund claims in a ruling issued November 26, 2001. After McGraw-Hill sought administrative review, the SBE upheld the FTB decision on May 29, 2003.

On September 24, 2003, McGraw-Hill pursued its statutory avenue for judicial review by filing a complaint in the superior court alleging that the FTB had unlawfully denied its claims for tax refunds.<sup>4</sup> (See Rev. & Tax. Code, § 19382.) On August 19, 2004, the FTB filed a motion for summary judgment in this action. The following day, McGraw-Hill filed its own cross-motion for summary judgment. The trial court conducted a hearing on the cross-motions in November 2004, and subsequently entered its order denying McGraw-Hill’s motion and granting that of the FTB. On February 8, 2005, the court entered judgment accordingly, and this appeal followed.

### **Discussion**

#### **A. Standard of Review**

We review an order granting a motion for summary judgment independently. (*Aguilar v. Atlantic Richfield Co.* (2001) 25 Cal.4th 826, 860.) Likewise, we conduct an independent review when, as here, the material facts are undisputed<sup>5</sup> and we are asked

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<sup>4</sup> McGraw-Hill’s complaint included a second cause of action alleging a right to tax refunds on unrelated grounds. This cause of action was settled by the parties and is not at issue in this appeal.

<sup>5</sup> The parties in this case submitted a joint stipulation of facts and other documentary evidence. To the extent the parties disputed each other’s statement of material facts, each essentially contested only the other’s characterization of the legal significance of undisputed facts.

only to determine questions of law. (*Regents of University of California v. Superior Court* (1999) 20 Cal.4th 509, 531; see also *J.H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, 983.)

B. *McGraw-Hill's Contentions*

Former IRC section 475 defined a “dealer in securities” to include a taxpayer who “regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business . . . .” (Former IRC § 475, subd. (c)(1)(A); see Pub.L. No. 103-66, § 13223(a) (Aug. 10, 1993) 107 Stat. 312, 482.) It also defined “security” to include, among other things, a “note, bond, debenture, or other evidence of indebtedness.” (Former IRC § 475, subd. (c)(2)(C); see Pub.L. No. 103-66, § 13223(a) (Aug. 10, 1993) 107 Stat. 312, 482.) McGraw-Hill argues that it comes within these definitions because it “regularly purchase[d]” customer paper—or “evidence of indebtedness”—in the ordinary course of business of selling goods and services to these customers. It was thereby a “dealer in securities” *required* by former IRC section 475 to use the mark-to-market method with respect to such customer paper for federal tax purposes. For this reason, McGraw-Hill claims it was entitled, pursuant to Legal Ruling 95-6, to amend its state tax returns for 1993 and 1994 in order to use the same method for state tax purposes.

C. *Treasury Regulation Section 1.475(c)-1 (TR 1.475(c)-1)*

McGraw-Hill takes the position that its interpretation of former IRC section 475 is supported by TR 1.475(c)-1. (See 26 C.F.R. § 1.475(c)-1 (2005).) This regulation, adopted in its final form in December 1996, states that a taxpayer is not a “dealer in securities” within the meaning of section 475(c)(1) if the taxpayer comes within the statutory definition *only* because of the purchase or sale of “debt instruments that, at the time of purchase or sale, are customer paper.” It defines “customer paper” to be a “debt instrument” that is signed over to a taxpayer whose “principal activity” is “selling nonfinancial goods or providing nonfinancial services,” by a customer seeking to finance a purchase of such goods or services, when that paper is not accounted as part of the taxpayer’s inventory and is held at all times by the taxpayer. (26 C.F.R. § 1.475(c)-1(b) (2005); see 61 Fed.Reg. 67715 (Dec. 24, 1996); 1997-1 C.B. 108; T.D. 8700.)

TR 1.475(c)-1 also sets out a procedure whereby such a taxpayer may make a positive election to opt out of this exception, so as to use the mark-to-market method with respect to its customer paper. (See 26 C.F.R. § 1.475(c)-1-(b)(3)(ii), (4) (2005).) McGraw-Hill reasons that this regulatory exception, as well as the procedure to opt out of the exception, makes no sense unless a taxpayer described by the exception would have come within the statutory definition of “dealer in securities” but for application of the exception.

We note that, although TR 1.475(c)-1 was adopted in 1996, it was applied *retrospectively* to cover tax years 1993 and 1994. (26 C.F.R. § 1.475(e)-1(h)(2) (2005); see 61 Fed.Reg. 67726 (Dec. 24, 1996); 1997-1 C.B. 108; T.D. 8700.) McGraw-Hill falls squarely within the regulation’s exception, as shown by the stipulated facts summarized above. Thus, even if McGraw-Hill might have come within the statutory definition of “dealer in securities” *but for* application of the exception set out in TR 1.475(c)-1, the fact remains that this exception *did* apply to McGraw-Hill during tax years 1993 and 1994, and McGraw-Hill was therefore never *required* by former IRC section 475 to use the mark-to-market method with respect to its customer paper held at the close of those tax years.

McGraw-Hill does not argue that TR 1.475(c)-1 is somehow invalid, and we see no indication of invalidity. The Treasury Department adopted TR 1.475(c)-1 pursuant to its general statutory authority and a more specific statutory authority to adopt regulation appropriate to carry out the purposes of former IRC section 475.<sup>6</sup> The regulation’s

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<sup>6</sup> The Treasury Department cited to Internal Revenue Code section 7805 and former IRC section 475(e) (see now 26 U.S.C. § 475(g)) as its authority for adopting the TR 1.475(c)-1. (61 Fed.Reg. 67719 (Dec. 24, 1996); 1997-1 C.B. 108; T.D. 8700.) Section 7805 gives the Treasury Department a general authority to “prescribe all needful rules and regulations for the enforcement” of the Internal Revenue Code (26 U.S.C. § 7805(a)), and former IRC section 475(e) granted the Treasury Department authority to “prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section . . . .” (Former IRC § 475(e); Pub.L. No. 103-66, § 13223(a) (Aug. 10, 1993) 107 Stat. 312, 484; see now 26 U.S.C. § 475(g).)

retrospective application was similarly authorized by statute.<sup>7</sup> When a Treasury regulation such as TR 1.475(c)-1 modifies an existing statutory definition, it is deemed to be “interpretive” of the statute, as distinguished from a “legislative” regulation that fills a statutory gap or omission pursuant to a specific grant of authority to do so. (See *E.I. du Pont de Nemours & Co. v. C.I.R.* (3rd Cir. 1994) 41 F.3d 130, 135-136.) Such a regulation “command[s] respect, for Congress has delegated to the Secretary of the Treasury, not to [the courts], the task ‘of administering the tax laws of the Nation.’ ” (See *Commissioner v. Portland Cement Co. of Utah* (1981) 450 U.S. 156, 169, citing *United States v. Cartwright* (1973) 411 U.S. 546, 550.) The regulation “ ‘must be sustained unless unreasonable and plainly inconsistent with the revenue statutes.’ ” (*Commissioner v. Portland Cement Co. of Utah, supra*, at p. 169, citing *Commissioner v. South Texas Co.* (1948) 333 U.S. 496, 501.) In determining whether to sustain a Treasury regulation, the federal courts consider whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. (*Rowan Cos. v. United States* (1981) 452 U.S. 247, 253 (*Rowan*).) Among their considerations is whether the regulation “ ‘is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent.’ ” (*Rowan, supra*, at p. 253.) Another is the

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<sup>7</sup> The Treasury Department is authorized to adopt a regulation that applies retrospectively to the date of publication of any preceding temporary or proposed regulation. (26 U.S.C. § 7805(b)(1)(B).) In this case, the Treasury Department published a temporary regulation in December 1993, which set out an exception substantially equivalent to that set out in the “final” version of TR 1.475(c)-1. (See Treas. Reg. § 1.475(c)-1T (Temporary TR 1.475(c)-1T); 58 Fed.Reg. 68748, 68750 (Dec. 29, 1993); 1994-1 C.B. 152; T.D. 8505.) Temporary TR 1.475(c)-1T was applicable to tax years ending on or after December 31, 1993, and was published to “provide guidance concerning the meaning of . . . statutory terms” set out in former IRC section 475, including the term “dealer in securities.” (See 58 Fed.Reg. 68747, 68751 (Dec. 29, 1993); 1994-1 C.B. 152; T.D. 8505.) Temporary TR 1.475(c)-1T stated that “[i]f the principal activity of a taxpayer is selling nonfinancial goods or providing nonfinancial services, the fact that the taxpayer extends credit to the purchasers of its nonfinancial goods or services does *not* make the taxpayer a dealer in securities within the meaning of section 475(c)(1), even if the taxpayer sells the evidences of indebtedness so acquired.” (Temporary TR 1.475(c)-1T(a) (*italics added*); 58 Fed.Reg. 68750 (Dec. 29, 1993); 1994-1 C.B. 152; T.D. 8505.)

“consistency of the . . . interpretation” of the regulation, particularly in light of any scrutiny it may have been given by Congress, as reflected by subsequent amendment. (*Rowan, supra*, at p. 253.)

The U.S. Tax Court has noted that the purpose of former IRC section 475 was initially to address concerns that related properly only to those whose primary business was the purchase and sale of securities and who commonly accounted for an inventory of securities. Many such dealers already utilized the mark-to-market accounting method in order to measure the net worth that they reported to shareholders and creditors, and former IRC section 475 was designed to require such dealers to use that method for federal tax purposes as well. (*Bank One Corp. v. C.I.R.* (2003) 120 T.C. 174, 279, 284, 296-300.) The interpretation set out in TR 1.475(c)-1, which excludes from the statutory definition of “dealer in securities” a taxpayer whose *only* claim to being a dealer in securities is the fact that it holds debt instruments arising from the extension of credit to customers buying nonfinancial goods or services, is more in harmony with this underlying purpose than the construction of the definition that McGraw-Hill urges. (26 C.F.R. § 1.475(c)-1(b) (2005).)

Moreover, Temporary TR 1.475(c)-1, adopted in December 1993, interpreted the statutory definition of “dealer in securities” in much the same way as the final version. (See fn. 7, *ante*.) This interpretation supports the conclusion that the regulatory exception set out in TR 1.475(c)-1 represents both a “. . . ‘contemporaneous construction [of former IRC section 475] by those presumed to have been aware of [the] congressional intent’ ” underlying that section, and also expresses a “consisten[t] interpretation” of that statute. (See *Rowan, supra*, 452 U.S. at p. 253; 26 U.S.C. §§ 475(g), 7805(a).)

McGraw-Hill suggests that TR 1.475(c)-1 does not apply in determining whether it was “required” by former IRC section 475 to use the mark-to-market accounting method for tax years 1993 and 1994 because the FTB did not mention that regulation in Legal Ruling 95-6, but only provided in that ruling that it applied to any “taxpayer *required* to change its method of accounting pursuant to [former] IRC section 475.”

The problem with this argument is that Legal Ruling 95-6 essentially applies former IRC section 475 for the purpose of making a determination under state tax law. The ruling rests on the proposition that, although current state tax law had not yet been explicitly “conformed” to former IRC section 475, its was “permissible” under state law for a taxpayer to change its accounting method to use the mark-to-market method in the event that former IRC section 475 applied to “require[]” the taxpayer to make the same change for federal tax purposes. “When applying the Internal Revenue Code for purposes” of either the state personal income tax law or the state corporation tax law set out in the Revenue and Taxation Code, the federal regulations that implement the Internal Revenue Code “shall be applicable as regulations under [such state law] to the extent that they do not conflict with [the state provisions] or with [FTB] regulations . . . .” (Rev. & Tax. Code, §§ 17024.5, subd. (d), 23051.5, subd. (d).) In other words, we cannot ignore the application of TR 1.475(c)-1 in determining whether former IRC section 475 “required” McGraw-Hill to change its method of accounting for tax years 1993 and 1994.

D. *The 1998 Amendment to Former IRC Section 475*

McGraw-Hill additionally claims that the 1998 amendment to former IRC section 475 supports its broad interpretation of that statute’s definition of “security” and “dealer in securities.” This amendment expressly excluded “nonfinancial customer paper” from the statutory definition of “security.” The amendment further defined “nonfinancial customer paper” to be an evidence of indebtedness that “arises out of the sale of nonfinancial goods or services by a person the principal activity of which is the selling or providing of nonfinancial goods or services,” and “is held by such person . . . at all times since issue.” (Pub.L. No. 105-206, § 7003(a) (July 22, 1998) 112 Stat. 685, 832; see now 26 U.S.C. § 475(c)(4).) In McGraw-Hill’s view, this amendment would not have been necessary unless such customer paper was included within the definition of “security” set out in former IRC section 475.

We disagree. The amendment actually demonstrates Congress’ subsequent legislative scrutiny that ultimately confirmed the Treasury Department’s regulatory interpretation of former IRC section 475 set out previously in TR 1.475(c)-1. Congress

accordingly conformed the statutory language. In any event, it is the scope of former IRC section 475, and not the intent underlying its 1998 amendment, that is at issue here. We conclude that scope is determined by application of the retrospective interpretation set out in TR 1.475(c)-1.

E. *The Effect of the IRS Decision*

McGraw-Hill urges that its interpretation of former IRC section 475 is supported by the fact that the IRS, after a “detailed . . . audit,” allowed McGraw-Hill’s amended federal tax returns for tax years 1993 and 1994, that implemented the mark-to-market accounting method for federal tax purposes.

We disagree because the IRS decision did not include any determination that McGraw-Hill was a “dealer in securities” who was *required* by former IRC section 475 to use the mark-to-market accounting method for those tax years. To the contrary, the record shows that McGraw-Hill did not file its amended federal tax returns until 1997, *after* the 1996 adoption of TR 1.475(c)-1. In filing these returns McGraw-Hill expressly relied on that regulation’s procedure for opting out of the regulatory exception so that it could use the mark-to-market method. (See 26 C.F.R. § 1.475(c)-1(b)(4) (2005).) The IRS decision merely “reviewed and accepted [McGraw-Hill’s] *elections*.” (Italics in original.)

We likewise reject McGraw-Hill’s related argument, that because it elected “not to be governed” by the regulatory exception, it was thereafter subject only to the literal definition of “dealer in securities” set out in former IRC section 475 and not the regulatory interpretation of that definition. (See 26 C.F.R. § 1.475(c)-1(b)(4) (2005).) McGraw-Hill reasons that it was consequently *required* to use the mark-to-market method under former IRC section 475. But the real and practical consequence of McGraw-Hill’s election was that the IRS permitted McGraw-Hill to use an accounting method it was not otherwise *required* to use.

F. *Conclusion*

In sum, we conclude that TR 1.475(c)-1 was a valid interpretation of former IRC section 475. This regulation was applicable to determine—for purposes of state tax

law—whether McGraw-Hill had been “required” by former IRC section 475 to change its accounting method to use the mark-to-market for federal tax purposes during the tax years 1993 and 1994. TR 1.475(c)-1 clearly excluded McGraw-Hill from the definition of a “dealer in securities,” and McGraw-Hill was accordingly never “required” under former IRC section 475 to use the mark-to-market method during those tax years. Legal Ruling 95-6 expressly applies only to taxpayers required to make changes pursuant to former IRC section 475. Consequently, McGraw-Hill was not entitled to amend its state tax returns pursuant to Legal Ruling 95-6, and the trial court correctly determined that the FTB was entitled to summary judgment as a matter of law. In light of this conclusion, we deem it unnecessary to consider McGraw-Hill’s final claim, that its amended state tax returns were not untimely under Legal Ruling 95-6.

**Disposition**

The judgment is affirmed.

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Marchiano, P.J.

We concur:

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Swager, J.

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Margulies, J.

*McGraw-Hill Companies, Inc. v. California Franchise Tax Board, A109907*